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# Serving the integrity of the Mammon and the compulsive excessive regulatory disorder

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## 'Financial brooks and creeks' and the 'financial Katrina'

Keen observers of criminal and licit finances and markets may realise we are living in a fascinating time. This fascination is not due to some sophisticated sinister criminal plot, but to the hilarious proportions of financial events and threats. We can look back at a time span of two decades of anti-money laundering and crime-money fighting policy. During these 20 years the US propelled FATF has elaborated a dense system of supervision, watching every little financial flow, brook and creek. Unwilling financial fishermen and game keepers have been pressured into compliance to protect the 'integrity' of the elaborate waterways by preventing criminally polluted water from slipping into the financial mainstreams. Those unwilling to go along were bullied into line by threatening them with enlistment on the black list of 'Non-cooperative countries and territories'. And while in the end an international compliant workforce emerged, humming and droning the 'financial integrity hymn', reporting diligently on all and sundry, an unprecedented 'financial Katrina hurricane' gathered pace. This time the main players were not sinister drug barons, but short-sighted, irresponsible bank managers, ranging from over-bonussed CEOs to middle level managers. They proved to be more concerned about their stock options than contributing to the integrity of the financial system by a sound lending and mortgage policy. While a trough of credit low pressure was gradually

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building up, the FATF and their FIU cohorts were still busying with financial transactions of 15.000[1] euros or money transfers of 2.500 euros: watching the brooks and creeks at the time when the clouds were binding which would ravage the ‘financial New Orleans’. The distorted proportions between the mini-FATF threats and the ‘financial credit Katrina’ are fascinating indeed. And if not so grotesque, they would be quite hilarious.

Of course, it would be inappropriate to raise the question “Where were the FATF and their allied gatekeepers”. Their task is not to watch irresponsible bankers providing sub-prime loans, but crime-money flows. This is a serious issue because two decades ago it has been declared serious. How serious? No one knows, despite recycled FATF assumptions [1] or politically acceptable, but methodologically flawed research (See: [2, 3]). It would be more appropriate to raise the question: “How could high-level financial policy makers in international bodies—expressing their “grave concern”—get so one-sidedly focussed on a phenomenon of which the threat potential has remained unproved?” The answer to this question will require a critical historical research: the “Making of the FATF and its global acceptance”. This would be a unique historical text book which goes beyond a short introduction to this special. But building blocks for such a historical research are already present in the form of non-mainstream papers, some of which are included in this special, though not written for such a historical review.

## Four building blocks

One historical building block may concern the confluence of roles and interests of the different players in the field of money-laundering. That does not mean that roles get fused such that they can no longer be discriminated. They become interconnected and mutually dependent and in the end form an ‘anti-laundering complex’.

In the first paper, *Antoinette Verhage* describes this phenomenon. She discerns three groups of players: the supervisors, seeing to the execution of the FATF ‘recommendations’, the financial institutions and all other entities obliged to report unusual/suspicious transactions and the commercial firms which sell ‘compliance services’.

The roles of these players can be characterised as follows. The FATF brandishes the big sledgehammer of the ‘Big Crime Money’, the commercial compliance firms provide the anvil—of course for a handsome fee—to the pressurised financial institutions to put their head on. The petrified institutions have no option but complying with the expensive anti-laundering regime. While duly humming the ‘financial integrity hymn’, they appoint expensive compliance staff or buy pricy compliance services. Failing to do so may lead to the sledge hammer coming down on their head: reprimands from the supervisors and (threat of) loss of reputation and income (which may be just a convenient assumption). Nevertheless, a PriceWaterhouseCoopers survey of 2007, mentions that 12% of the interviewed companies thought money-laundering a high risk,

[1] All numbers in this special are written according to the European Continental annotation: commas for decimals and dots between thousands.

while only 4% of them reported any own laundering experience. This contrasts with the many fear images of 'embedded experts', pointing at the negative effects of the laundered crime-money: the disruptive effects on the economy and the financial system. The effects mentioned encompass: increase of inflation due to the influx of crime-money (but despite all laundering, low in the Euro zone and otherwise determined by world commodity prices); unstable interest and exchange rates (steady in the Euro zone); infringement on fair competition (but main infringements come from licit corporations engaged in illegal cartels).

Given this list of contra-indications, we appear to have little to fear from money-launderers, at any rate in the Euro zone. But the obliged institutions will be to be the last to point at this plausible assumption. Instead, they comply after some silent grumbling and are glad to see that the sledgehammer remains hovering in the air. This applies to the financial institutions as well as the internal compliance officers. The latter feel themselves in the institutions between the supervisors' hammer and their money-making colleagues, a kind of local mini-anvil. This is not a theoretical picture: based on their responses to a questionnaire Verhage introduces us to the compliance officers within the banks: she gives them a face and a voice.

Naturally, they grumble about some technical aspects in their job, but in general they are proud of their work: "*Today, without compliance, a bank can no longer function*". This is not because of all the real threat they succeed in fending off. As a matter of fact, the real 'threat frequency' is low while the officers think that their compliance tasks actually slow down the handling of financial transactions. No, they are proud because they do detect suspicious transactions, giving them the feeling that a proper and recognisable compliance enhances the radiation of trustworthiness. The idea of a kind of 'laundering green label': "This is a feel-safe bank". Self-delusion, as we will see.

As is the case with so many tasks, institutions must decide whether compliance is a real banking task or whether certain facets should be outsourced. For example, training, development of electronic tools, consultancy etc. are aspects of the compliance tasks which banks may be willing to outsource. Hence, a market of compliance services and tools emerges in which the threat of crime-money is converted into licit money. Is this not the iron-cast formula with a high degree of self-perpetuation? Yes, one can observe it repeatedly in the history of the threat industry. It consists of a threat image (Crime-Money), an executive entity (banks) and commercial service providers (security firms of various special tasks). Of course, such a trinity cannot emerge and survive alone: it needs a surrounding social and political mainstream in which politicians, law enforcement agencies and (embedded) researchers are willing to turn assumptions into 'facts'.

Meanwhile the integrity hymn is turned into a war song with 'war', 'fight' and 'combat' being the highest frequency words. In this regard, *Liliya Gelemerova*'s paper 'On the front line against money-laundering' is interesting. As in wars intelligence is vital, she directs her attention to the financial intelligence units at the frontline: the FIUs. Her review of the development of this intelligence function shows that it was the US agency FinCen (established 1990) which took a clear lead (as can be observed in the whole money-laundering portfolio). FIUs sprang up like mushrooms in an increasing number of jurisdictions entering (or being herded) into the FATF perimeter.

Meanwhile a shift towards widening the US jurisdictional circle could be observed: FinCen would also provide assistance to the Treasury in the *international* fight against money-laundering. Looking at similar usurpation of international powers in the War on Drugs more than half a century ago [4], this was not a surprising extension. Another predictable shift was the broadening of the list of predicate crimes and institutions obliged to report. The dimensions of the anti-money laundering regime started to grow quickly. After 2001 terrorist financing was included and at last the politically exposed persons (PEP) because of potential corruption money.

The author observes that meanwhile for practical purposes the concept of money-laundering was broadened so widely as to encompass all movements of unrecorded monies related to the underground economy. This broad concept is not very precise and does not contribute to a clear and efficient intelligence process. In addition, it was recognised that working with a list of not very clear indicators and often trying to over-comply with regulations without assessing the actual risks, led to an unwieldy flow of suspicious transaction reports, of which an increasing portion ended in a later-to-be-used box (later a freight container). Hence, the *risk based* approach was adopted to reduce the flow of false positives. However, what means 'risk of money-laundering', given the fuzzy definition of laundering itself? When we add to this the implications of the somewhat half-baked requirements concerning Politically Exposed Person, we have some idea of the ensuing confusion which is bound to blunt the intelligence weapon.

Of course, organisations can learn from experience and reshape or sharpen their tools. However, such a learning process cannot develop without feedback. At this point one can observe internationally a systematic shortcoming between the agencies receiving and handling suspicious transaction reports: the FIUs provide insufficient feedback to the 'financial gatekeepers'; the police irregularly feedback to the FIUs; the Prosecution hardly gives feedback to the police and the Courts to no-one unless the verdict is published in the newspaper. So, how do the players in the field learn from wrong risk assessments? They only know that overlooking right laundering risks may entail the real risk of becoming reprimanded by the supervisors. To avoid that risk, the best the financial gatekeepers can do is to extend their conception of risk and report again every money movement that looks a bit unusual. Consequently the quality of the intelligence will not improve, the dimensions of the FIU frontline will increase and the concept of risk will become another hollow buzzword.

From the previous section one can deduce that the financial service providers are very much aware of their prime risks: *reputation damage* and the *supervisors* (rather than the real laundering) which may detect non-compliance which again affects the reputation. This is elaborated in the third article by *Jackie Harvey* and *Siu Fung Lau*. They show that in the perception of banks proper compliance is perceived as a prevention of reputation loss, rather than as something to enhance their status. This may explain why the financial institutions are pretty silent about their anti-laundering compliance measures in their annual reports: most disclose just the minimum of information about regulatory issues and measures to counter laundering. About the expenses of their compliance policies the financial sector remains silent! There is certainly no public compliance advertisement to draw the attention of the public to one's 'laundering green label': "We are the Most

Compliant" (and spend the most on checking you!). This falsifies the frequently stated idea that compliance would be used as a competitive tool which may drive the institutions into an enhancing 'virtuous cycle of compliance'. (This contradicts the perception of the compliance officers in Verhage's paper: sadly they may just delude themselves).

Why should the banks let themselves drive to such an enhancement? That would only make sense if public awareness of the money-laundering issue would be high. That is not the case. The analysis by Harvey and Lau demonstrates that there is no correlation between (the low) money-laundering coverage in the UK press (as a measure of public awareness) and the number of words devoted to it in the banks' reports. Even fines imposed because of compliance failures did not stir the press, let alone the public. Naturally, things would be different if the customers would lose their savings because of laundering activities. But launderers do not steal money *from* the banks; they bring money *to* the banks. Only managers (may) steal or put their customers' savings at risk and get away with a fat bonus.

For good reasons the authors conclude that there are no foundations for the threat rhetoric in the policy papers and other articles. There is no unambiguous relationship between compliance and reputation. There may even be an inverse one: trust in a laundering bank. As long as Luxembourg or Liechtenstein succeeded in protecting the tax fraud savings of thousands of Belgians and Germans, the reputation of these banks was high. This public reputation was not undermined by a potential drug baron among these normal secrecy loving customers, but by stealing employees, selling the records of customers' names to the Belgian and German Tax Services. In earlier sections I mentioned the lack of evidence of threat to monetary stability, inflation or fair competition. Add to this the authors' observed lack of correlation between reputation and compliance, another conventional argument in favour of a strict and expensive regulatory policy evaporates.

Even in the real estate market, frequently rated as highly vulnerable to laundering activities, there is no evidence of worrying inroads [5]. True, much crime money is invested in property but business property (for example apartments for rent) has a low frequency while other effects are difficult to measure. Crime-money owners are certainly not in a position nor intended to wreak havoc in the real estate market, which is rather victim of US under-regulation.

Despite this lack of systematic evidence—going beyond the recycled FATF anecdotes or typologies—the anti-money laundering regime has been extended to all commercials sectors in which people with suspicious money may place their dirty cash. This applies to the real estate sector, and dealers with all sorts of valuables: cars, antiques (no laundering with Picassos or Rembrandts!) and jewellery dealers. The last mentioned sector, particularly concerning diamonds, is covered by the fourth author, *Maarten van Dijck*. Of course, there are many anecdotes of criminals as well as terrorists possessing diamonds, which represent an efficient value carrier, being light to carry while they do not smell. But laundering crime-money by means of diamonds? This is a highly specialised world of trust and specialist knowledge. With a little velvet sack full of diamonds one cannot say: "Count your money". An inexperienced launderer may end up with a sack of glass. This uncertainty lowers the laundering risks.

Nevertheless, the world of diamonds being based on trust also lacks transparency and devoted transparency champions like the FATF do not like such dusky economic niches. Consequently the diamond sector has been brought within the laundering regulation orbit too. The phenomenon of ‘blood diamonds’ also helped in convincing all relevant parties that regulations were necessary to prevent the revenues of the irregular diamond trade falling into the hands of warring parties in West-Africa. However, the Kimberly Certification Process mainly covers the mined diamond which does not play a significant role in funding the local wars. It did not prevent the smuggling of *alluvial* diamonds to neighbouring non-conflict countries where they may get their ‘clean’ certificates nevertheless. One may call this ‘origin laundering’. Also otherwise, the anti-laundering regime seems to be directed at diamonds related cash transactions above € 15.000 in the Western countries where most of the retail trade takes place, as well as the upper level trade.

Nevertheless, despite the lack of evidence that diamonds play a significant role in criminal money management, as soon as the relevant recommendations had been issued the diamond sector did not lose time to comply with the anti-laundering regulations if only by way of lip service. Here also the concern for reputation may have been the main driver. According to Van Dijck this has contributed to transparency in the sector. Given this lofty objective, what is the evidence that on top of that there is any added value in fighting money-laundering in the diamond market or other high-value object markets? It is true, criminals like expensive shiny things: in the Dutch confiscation database I found 333 hits for the search word ‘diamond’. But this frequency should be offset against time: this database runs from 1994 onwards. Hence a frequency of 333 does not look like an impressive threat. Even if one adds all the other gems, watches (with diamonds), golden lighters (Dupont), Swarovski crystal (buckets full!) and other bling-bling there is no threat. Most of these bling-blingies were for dressing up mom or a girlfriend if they went out shopping in expensive shopping malls. But we found no trace of laundering with diamonds or other expensive glittering things [5].

## Compulsive excessive regulatory disorder

Here I am back at the opening metaphor: the anti-laundering regime as a huge financial all brooks-and-creeks encompassing supervision system. It is enormous, but it certainly does not reflect an ‘intelligent design’. It lacks any feeling of its own (small) proportion in the whole or a larger view on the risks within the whole financial system, where the real dangers—stemming from ‘greeditalism’—appear to be looming. This global investment in myopic nosing around in transactions without any clear sign of ‘victory’ gives the whole anti-laundering regime such an out-of-proportion appearance. I do not want to belittle the issue: money-laundering does exist and there are sound reasons to suppress it in favour of financial transparency and honesty. But I feel puzzled about this relentless anti-laundering chase without much thought devoted to a cost-benefit analysis [6]. I am equally puzzled by the lack of analytically reasoning statements and arguments to their logical conclusions. Take the buzzword ‘risk’ and the encouragement to adopt a risk-based anti-laundering policy. If the anti-laundering policy is to be based on the risk principle in individual compliance cases, that principle must likewise be applied to whole economic sectors, jurisdictions or to the broader laundering policy as such. That implies that policy implementations must be based on the answer to risk assessing questions such as: “What is the likelihood of money-laundering in a particular economic sector and how to relate this to a certain intensity of supervision.” Should we lower the intensity if the risks prove to be low? Such a serious risk based approach, taking account of proportionality, has clearly not been adopted thus far.

Given the discrepancy between proclaimed threats and financial reality this risk perspective looks surprising against the background of strange contradictions. On the one hand the FATF and policy makers continue to issue warnings of looming threats, while on the other hand, the apparently unconquered laundering phenomenon[2] still hardly creates a wavelet in the financial system of the industrialised world. I would welcome well-substantiated examples of national budgets or a Central Bank in the G-7 countries, which has become under pressure because of laundering (excluding the usual income tax fraud).[3]

It is telling that this question is not raised by the FATF or the authorities let alone researched. That might evoke a debate, which has been lacking (or avoided) thus far. This lack of debate is quite understandable, because there is no reason for policy makers to engage themselves in any debate with outsiders: they debate among themselves or with politicians being in the same law enforcement mood. Assuming the unlikelihood that an open debate will unfold, I think it would be more fruitful to consider a innovative behavioural research project on “The making of the anti-money laundering regime” as mentioned in the first sections. Research questions abound. Why were implausible figures accepted with so much gullibility? Why are such rambling definitions taken for granted and applied? Why are policy makers keen on severe legislations in jurisdictions and sectors hardly threatened by crime-money (apart from the moral adage “crime must not pay”)? Perhaps we are observing a special socio-political behavioural syndrome: a “Compulsive Excessive Regulatory Disorder” (with an acronym—CERD—otherwise it is not taken seriously).[4] This is a serious research-appeal to social psychiatrists making us understand the behavioural aspects of the anti-laundering drive.[5]

As remarked before: I hope the reader may value the contributions in this special as valuable first building blocks. May he add his own.

[2] As far as the UK drug market is concerned, the fight against drugs and money is not very successful, given the declining prices over the last years as mentioned by [7] quoting SOCA’s figures.

[3] Inversely, the credit crisis in the financial upperworld may seriously impact on laundering and criminal savings: how much crime-money is evaporating and will induce to a criminal rush to ‘de-launder’ crime-money?

[4] “Regulatory autism” may also catch the meaning. This has also a counterpart: “compulsive de-regulatory disorder”, which has been the basis of US foreign investment and financial policy [8] It is a plausible hypothesis to consider this policy as the breeding ground of the present credit crisis.

[5] An historical example is the US driven penal law drug policy. In the near future we can expect a manifestation of the CERD-syndrome directed at tobacco consumption to be followed by fighting the ‘calorie threat’.

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